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FM AMEMBASSY ANKARA
TO RUEHC/SECSTATE WASHDC 2618
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUEHIT/AMCONSUL ISTANBUL 2888
RUEHDA/AMCONSUL ADANA 2050
RUEHBS/USEU BRUSSELS

UNCLAS SECTION 01 OF 03 ANKARA 001537

SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - JROSE

SENSITIVE
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REF: ANKARA 1031 AND PREVIOUS

E.O. 12958: N/A
TAGS: EFIN TU
SUBJECT: Government Officials Deny Election-year Fiscal Loosening

¶1. (SBU)Summary: A series of Government announcements on fiscal policy have led to increased suspicions of populist, election-year fiscal loosening. The most high-profile and IMF-unfriendly of these was the announcement of Value-Added Tax rate cuts for tourism food and restaurants. 2007 tax revenues are also showing signs of weakness. Both Government ministers, publicly, and ministry of finance bureaucrats, privately, deny or downplay the significance of policy changes and claim they will still be able to meet yearend fiscal targets. End Summary.

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Signs of Fiscal Loosening
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¶2. (SBU) In recent weeks there have been a series of Government announcements and press reports suggesting the government is taking populist spending or tax policy measures which could undermine fiscal discipline. Among these have been:

---Cutting Value-Added Tax (VAT) rates on some foods to 8%, effective immediately, and on tourism, restaurants, and remaining food items effective in 2008;

--Expanding the regional investment incentives to allow firms with only ten employees to benefit from the incentives, and removing the requirement that the employees be new hires;

-- Reducing social security payroll taxes in 2008;

--The press has also reported such items as free government circumcisions, payments to holders of bonds fraudulently sold by the failed Imar Bank, amnesties on loans to farmers, conversions to permanent status of public sector temporary workers, and partial debt forgiveness for municipalities.

¶3. (SBU) As a result, market analysts are increasingly concerned that the government is loosening the purse strings in the run-up to July 22 elections and will have difficulty achieving yearend fiscal targets agreed with the IMF. After the VAT rate cut was announced, Finance Minister Unakitan denied it was a violation of the government's commitments to the IMF, only to be publicly contradicted by the IMF Resrep. More recently, IMF Deputy Managing Director John Lipsky, in Istanbul for the annual Investors Advisory Council, lamented the VAT rate cuts but said any election-year loosening would not "break the bank," and should be viewed in the context of the overall performance in Turkey. The IMF has long made the case that only after revenue collection improved could rates be cut, and that they be cut across the board rather than sector by sector.

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Data Show Spending on Track, but Weak Revenues
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¶4. (SBU) January-May central government fiscal data, however, do not show a notable opening of the fiscal spigot. Total non-interest expenditures were YTL 59.8 billion or 39% of the full-year target. This level of spending -- broadly in line with the target -- supports a mid-level budget official's claims that any election-year spending was minor, and that the government would not have any real problem meeting the yearend primary surplus target or falling within the IMF-agreed spending cap.

¶5. (SBU) The revenue side on the other hand, showed surprising weakness. Total January-May tax revenues increased only 8% in nominal terms from the same period in 2006 -- i.e. tax revenues fell in real terms and as a percent of GDP. Corporate tax receipts declined 9%, Special Consumption Tax collections declined 1% and VAT increased only 4%. The weak revenue performance raised questions as to the government's willingness to collect taxes aggressively in an election year.

¶6. (SBU) Thanks to privatization revenues and profit transfers from state-owned banks and the Savings Deposit Insurance Fund, the overall budget balance was a modest YTL 3.3 billion deficit, only 20% of the full year targeted deficit, and the primary surplus was 56% of the full-year target. The IMF, however, does not include privatization and profit transfers in its primary balance calculation, since the GOT committed not to spend this kind of one-off revenue. By the Fund's calculation, the January-May primary balance is only 31% of the full-year target.

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Tax Administration Explains Weak Revenue Performance...
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¶7. (SBU) Like his budgetary counterpart, a Deputy Director of the Tax Administration, while admitting to fiscal impacts from the rate cuts and other measures, downplayed the extent of the problem. The tax official offered a point-by-point explanation of the relatively weak revenue performance. Corporate tax revenues only looked weak in relation to the first 5 months of 2006 because the corporate tax rate reduction from 30% to 20% had come into effect as of April 1,
¶2006. Special Consumption Tax (SCT) collections were weaker largely because of the slowdown in domestic sales of automobiles, a major source of SCT revenues.

¶8. (SBU) The Tax Administration official explained that the slowdown in VAT collections was entirely attributable to a surge in VAT rebate payments to exporters. Gross VAT collections were growing at a healthy 14-15% rate but rebates had surged about 35%. Though much of this surge can be attributed to strong export growth so far this year, the Tax Administration was investigating firms showing outsized increases in rebates. (Comment: Combating export tax rebate fraud has long been a challenge for the Tax Administration. End Comment.)

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...denies Government going soft on collections...
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¶9. (SBU) The tax official denied that the Government was going soft on tax collection in an election year. On the contrary, the Tax Administration continued to implement its restructuring -- a key structural reform supported by the IMF and World Bank -- which is designed to improve tax enforcement and collection. The Tax Administration now has regional offices -- as opposed to less effective Finance Ministry offices -- in 29 provinces accounting for 94% of total tax revenues. The IMF-mandated Large Taxpayer Unit has been established in Istanbul to handle the 500 largest taxpayers (soon to be expanded) and has its own special team of auditors. The Tax Administration continues to invest in more elaborate information technology systems. Its improved data base now allows auditors to monitor taxpayers' bank account data, for example. The

Tax Administration is working with the EU to establish a risk-based auditing system which will better identify which taxpayers should be audited.

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...but Admits Costs Associated with Policy Changes
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¶10. (SBU) The Tax Administration Deputy Director admitted there were costs associated with some of the recently-announced measures. His boss, Tax Administration Director Osman Arioglu, had announced publicly that next year's VAT rate cuts would cost about 800 million YTL (about $600 million) and that the immediately-effective food VAT rate cuts would cost about 100 million YTL this year. In our meeting, the Deputy Director defended both the tourism rate cut as necessary to bring Turkey's taxes on tourism into line with competitor countries, most of which had single digit VAT rates for the tourism sector. He said the lower VAT rate for restaurants, while discouraged by an EU directive, was allowed by derogations for many accession countries and still exists in many of the pre-enlargement EU-15 countries, in some cases at rates lower than Turkey's 8% rate.

¶11. (SBU) The government has yet to disclose the details of its plans to cut social security payroll taxes, but a five percent cut was recently floated by Minister Unakitan. The Tax Administration official confirmed that this cut would be part of a package of labor market reforms the Government is working on with the World Bank, which is expected to be announced after the new government is formed. He said the income tax withholding on wages was only 6%, whereas the social security taxes accounted for the bulk of the tax "wedge": 14% from the employee and 19% from the employer. Comment: World Bank officials tell us their studies show that any tax loss from lower payroll taxes will be partially offset by increased registration of employees with the social security system, as lower payroll taxes reduce the incentive not to register. End Comment.

¶12. (SBU) The Tax Administration confirmed that parliament had passed legislation expanding access to the (IMF-opposed) regional investment incentives scheme. Whereas in the past firms had to employ 35 new hires to be eligible for the incentives, under the new law they would only need to have 10 employees and they need not be new hires. He expects a loss of revenue from this change of approximately YTL 900 million per year.

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Comment
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¶13. (SBU) Government Ministers' statements that they are not relaxing fiscal discipline are contradicted by the announced measures. Nevertheless, as Lipsky's remarks suggest, the measures so far do not seem severe enough to put yearend targets -- or agreement on remedial measures with the IMF -- out of reach of the next government.

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